

# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## THESIS



**PUBLIC OR PRIVATE: THE OUTSOURCING  
DILEMMA WITHIN THE DEPARTMENT OF  
DEFENSE**

by

Elizabeth A. Snyder

March, 1995

Thesis Co-Advisors:

Jerry McCaffery  
L. R. Jones

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THE DEPARTMENT OF DEFENSE**

by

**Elizabeth A. Snyder**  
**Lieutenant, United States Naval Reserve**  
**B.A., University of Alabama at Birmingham, 1986**

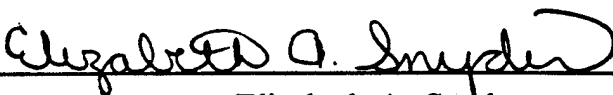
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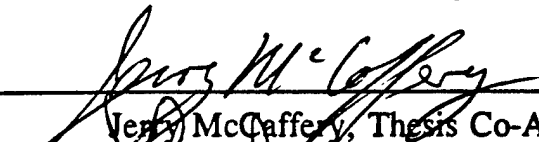
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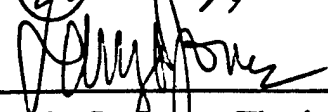
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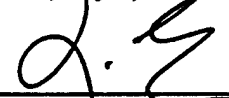
Author:

  
Elizabeth A. Snyder

Approved by:

  
Jerry McCaffery, Thesis Co-Advisor

  
L. R. Jones, Thesis Co-Advisor

  
David R. Whipple, Chairman  
Department of Systems Management



## ABSTRACT

This thesis investigates the outsourcing experience of Commander, U.S. Naval Air Force, Pacific Fleet's experience in implementing an outsourcing initiative as directed by the Chief of Naval Operations. Concerns regarding outsourcing identified are cost growth and administrative. Cost growth concerns include statutory wage rate increases for contractors; changes in contract requirements; deficiencies in written statement of contract requirements; poor contract administration and surveillance; and lack of competition for contracts among contractors. Administrative concerns include lack of contracting authority at the fleet level and loss of control of resources; reduced flexibility; profit motives of contractors; and potential of contractor corruption. Recommendations include determining exact requirements and stating them unambiguously in the contract; intensifying training for contractor administrators; factoring in the costs of oversight; ensuring that a competitive environment exists among contractors prior to outsourcing; and taking stringent precautions against contractor corruption.

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## I. INTRODUCTION

### A. THE POST-COLD WAR FISCAL CRISIS

The United States government is confronting a deepening crisis. It is currently caught between the need to provide basic services to an expectant public and a shortage of dollars to fund these services. Consequently, the search continues throughout all levels of government for remedies to this increasingly complex dilemma.

The pattern of American military spending over the past 50 years resembles a feast or famine cycle. Since the end of World War II, the defense budget has lacked consistency (Friedberg, 1991). The days of famine are upon the Department of Defense once again. It is to be hoped that Congress will break this cycle in military spending. The threats to national security are changing in shape but they nevertheless continue to exist. Future levels of defense spending must be high enough to permit a quick transition to a more active posture if required (Friedberg, 1991).

The harsh economic realities of the 1990s have put government officials across the country in a bind: in the face of rising costs and declining revenues, the DoD is asked to maintain the scope and quality of services that voters expect. More must be done with less. Taxpayers are reluctant to approve tax increases, not only making it difficult to add new services but sometimes making it difficult to continue providing services at current levels (Rose, 1994). How is the government to operate more efficiently with less funds?

## **B.    OUTSOURCING REDISCOVERED**

A number of city, county, state, and even federal officials are turning to the private sector for at least part of the answer. They have allowed businesses of all sizes to take over many of the services formerly performed by civil servants and even some of the facilities traditionally built, owned and operated by governments. (Holzinger, 1992)

This process, is most commonly called privatization, a term coined by Peter F. Drucker, a management specialist, in his book *The Age of Discontinuity*. Privatization or outsourcing<sup>1</sup> is the practice of delegating traditionally public duties to private organizations (Fitzgerald, 1988).

### **1.    Reasons for the Trend**

Support for the outsourcing movement gathered momentum over the past ten years. "Government should spend more time governing and less time providing. Government should purchase services from the private sector or stop producing." (Fitzgerald, 1988) Studies have been conducted to compare private industry to its government agency counterpart and have found private industry to be more efficient. Based on these findings, the Department of Defense is looking to make use of any advantages outsourcing has to offer.

A recognition of systemic failure to control debt at the Federal level has accelerated the need for change. An undercurrent away from reliance on traditional government approaches and a move toward a novel application of self-help and private sector strategies to deliver social need

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<sup>1</sup> The terms "outsourcing" and "privatization" will be used interchangeably.

permeates government agencies. Former New York Governor Mario Cuomo stated, "It is not the government's obligation to provide services, but to see that the services are provided for." Government should not be a producer of services, but a skilled shopper locating producers that will accomplish goals set by government at least possible cost. (Fitzgerald, 1988)

### **C. AREA OF RESEARCH AND RESEARCH QUESTIONS**

This thesis investigates the practicality of adopting a vigorous outsourcing initiative within the Navy as the DoD attempts to meet the challenge maintaining readiness in the face of dwindling resources.

#### **1. Primary Question**

The primary question addressed in this thesis is: What has been the experience of a Navy command with outsourcing from a managerial perspective, what concerns have developed, and what conclusions can be drawn from this experience?

#### **2. Secondary Questions**

In answering the primary question, the following secondary questions will be addressed:

1. What is the definition of outsourcing?
2. What are the issues involved in outsourcing?
3. What are the some of the major positive and negative aspects of outsourcing?
4. What are some general lessons learned from outsourcing in other government agencies and do they reflect those experienced by the Navy?

#### **D. SCOPE**

This thesis will primarily focus on one component of the Navy, COMNAVAIRPAC, located in San Diego and will:

1. report the outsourcing process followed by COMNAVAIRPAC;
2. identify some concerns relative to outsourcing based on opinions of involved personnel;
3. compare the experiences of COMNAVAIRPAC to that of other government agencies that have outsourced and;
4. provide conclusions and recommendations regarding the effectiveness of outsourcing in the COMNAVAIRPAC case.

Time does not permit this thesis to explore a cost comparison of a base operated utilizing in house resources with that same base contracted out. Further research in this area would be of extreme interest to the Navy and DoD as more and more outsourcing initiatives of this type are executed.

#### **E. METHODOLOGY**

A wide variety of references was used in the collection of data for this thesis to obtain historical information, current issues and facts. The methodology used to gather data entailed a thorough literature search and examination to acquire background information and the general theory behind outsourcing, and the use of the INFOTRAC resource to collect current views and opinions regarding the outsourcing, its effectiveness, advantages and disadvantages.

Interviews with key personnel at COMNAVAIRPAC involved in the outsourcing process such as the the Comptroller, Budget Officer, and Shore Activities Activities personnel

were conducted to provide expert opinions on the implementation and overall effectiveness of the outsourcing initiative.

#### **F. BENEFITS OF RESEARCH**

This thesis will benefit the Navy and the DoD. With the increasing pressure on the military to efficiently manage limited resources, it becomes critical to make the DoD budget stretch further than it ever has before. Outsourcing has been viewed as a possible solution to meeting targeted budgets cuts while maintaining readiness of forces, quality of service, and cost effectiveness.

This thesis will report how a Navy command is dealing with outsourcing issues as they attempt to comply with new DoD initiatives toward outsourcing. What occurs at COMNAVAIRPAC may be indicative of what is occurring at other commands throughout the Navy and DoD. Issues that are discussed and recommendations proposed within this thesis may assist decision makers in arriving at an informed decision either to outsource or to maintain a service in house. Follow-on research may provide clear financial advantages/disadvantages to maintaining production of a good or service in house or opting for the outsourcing alternative.

#### **G. ORGANIZATION OF RESEARCH**

This section briefly describes the content organization of the remainder of the thesis.

Chapter II (Background): Chapter II begins by describing the history of outsourcing and how the concept has

regained support since the promulgation of OMB Circular A-76 (Performance of Commercial Activities). Outsourcing is defined, and reasons for its resurgent popularity are examined. A discussion of the general advantages and disadvantages of outsourcing, and the identification of some distinctions between the public and private sectors concludes the chapter.

Chapter III (Outsourcing in Practice): This chapter discusses the case of COMNAVAIRPAC. A background case of successful outsourcing (Mustang, Oklahoma) will be discussed and then background information on COMNAVAIRPAC to include mission, responsibilities, and resources is presented. A detailed description on COMNAVAIRPAC's current outsourcing posture follows along with their experience in the management of outsourcing and opinions of key personnel involved with the outsourcing process.

Chapter IV (Analysis): The data presented in Chapter III is discussed and analyzed. Specific concerns regarding outsourcing are identified by COMNAVAIRPAC personnel.

Chapter V (Conclusions and Recommendations): This last chapter discusses the possible ramifications of the outsourcing experiences of COMNAVAIRPAC and what implications these experiences may have for the rest of the Navy and DoD. Independent conclusions are drawn from the data gathered, and recommendations follow to end the chapter and thesis.

A list of references and an extensive bibliography are included to assist readers in further readings on the topic.

## **II. BACKGROUND OF OUTSOURCING**

### **A. INTRODUCTION**

In times of ever-shrinking budgets and uncertainty regarding service demand that the future may hold for the Department of Defense, outsourcing is being closely examined for use as a management tool to offset budget reductions. The concept is not new (Holcombe, 1991). The federal government officially recognized the advantages of privatization years ago in OMB Circular A-76, "Performance of Commercial Activities" (HASC 101-31, 1990). A-76 requires agencies to contract with the private sector whenever that option would cost taxpayers less than providing comparable goods and services with federal employees (Holzinger, 1992).

The interest in privatization grew explosively in scope and intensity throughout the 1980s under the market-oriented administration of President Reagan as a way of more efficiently producing goods and services that were traditionally provided by the public sector (Holcombe, 1991). Longtime observers suggest that this interest is at an all-time high today, not only in this country but also throughout the world (Holzinger, 1992). Privatization's appeal is strong during a time when hard-pressed public officials search for ways to save money and provide services more efficiently (Morgan, 1992).

### **B. OUTSOURCING DEFINED**

What is outsourcing? There are nearly as many ways to define it as there are people to give definitions. Privatization can be described as occurring when the



government disengages from specific kinds of responsibility or deregulates entry into activities that were previously public monopolies. As defined by Webster, privatization is the process of changing from public to private control or ownership.

At its broadest level, privatization involves the introduction of market forces into an economy, the shifting of government goods or services into the private sector (Nuskey, 1992). E. S. Savas describes it as more reliance on private sector institutions and less on the government to satisfy social needs (Fitzgerald, 1988).

The Grace Commission maintained that privatization is "to provide services without producing them." (Kettl, 1988) For the purposes of this thesis, it shall be defined as government simply choosing to delegate a particular service to the private sector as opposed to continuing to perform that task with in house personnel or resources.

Privatization carries with it many connotations. Ideally, it involves transferring as many programs as possible to the private sector where the pressures of competition will improve efficiency. Those programs remaining would rely more on the private sector with its superior incentives to administer them. The government would be left to make basic decisions but the private sector, to the extent possible, would implement the directed course of action (Kettl, 1988). Outsourcing does not entail utter

abandonment of federal responsibility to private enterprise, it merely denotes a shifting of performance vice responsibility for services rendered.

Adam Smith in *The Wealth of Nations* concluded that, "no two characters seem more inconsistent than those of trader and sovereign." (Hanke, 1987) In other words, the business of government is not to be in business for profit.

In an effort to open up traditionally government provided services to the private sector, OMB circular A-76, "Performance of Commercial Activities," established a government-wide policy that government should obtain commercial services in the most cost-effective manner possible. Agencies are required to determine if it is more economical to retain the work in house or contract out to the private sector (HASC 101-31, 1990).

Whenever the private sector can perform a given service or task at a lower cost than the Government it should be given the task. (Hanke, 1987) The intentions of A-76 were to generate competition, not merely force the contracting out of jobs (HASC 99-46, 1986). Privatization is a general effort to relieve the disincentives toward efficiency in a public organization by subjecting them to the incentives of the private market (Hanke, 1987).

#### **C. REASONS FOR THE POPULARITY OF OUTSOURCING**

As previously mentioned, outsourcing is not a new idea, so what accounts for the resurgence in popularity of this concept? There are three major reasons: (1) The growing cost-revenue squeeze on the government; (2) public

disillusionment with government programs and; (3) the magnitude of the federal deficit.

### **1. Growing Cost-revenue Squeeze**

The growing cost-revenue squeeze on the government is forcing agencies to reassess the way they do business. Competition for scarce monetary resources motivates managers to conduct operations in the most economically efficient way possible while maintaining established quality standards.

Within a large agency such as the Defense Department, if it is determined that requirements can be met by performance of either government or a private organization, a cost comparison is conducted to determine the most economical method of operation. In many cases, the private organization appears superior (Nuskey, 1992). The increased efficiency, competition, improved quality and innovation all point to the flexibility, responsiveness and cost effectiveness of privatization.

### **2. Increased Public Disillusionment**

The American public has become increasingly disillusioned with government programs. The intellectual climate of the American people supports a turn away from government programs and toward private enterprise. A less naive view of the administration of such programs has colored the opinions of the people, who are beginning to lose faith with Uncle Sam to provide basic services and look to the entrepreneurs among society to take up the slack.

### **3. The Magnitude of the Federal Deficit**

The magnitude of the federal deficit has also served to influence the trend toward outsourcing (Fitzgerald, 1988). The promise of reduction of public outlays, taxes, and borrowing requirements is great incentive to look outside the government and to the private sector. The government's fiscal condition has been widely reported and analyzed. The budget deficit continues to rise and with it, the federal debt. Servicing the debt costs taxpayers approximately \$200 billion annually, it can therefore arguably be said that the government is facing a fiscal crisis not experienced since the Great Depression (CBO, 1982).

#### **D. BENEFITS OF OUTSOURCING**

A number of benefits of outsourcing are most often cited by proponents of the concept. Firstly, by contracting out a government provided service to the private sector, the government is released from the day-to-day operations (Mangravite and Moffitt, 1993) and relegated to providing oversight and is subsequently able to devote greater effort toward long-term goals and other priorities.

Secondly, the injection of competition into an environment previously insulated from market influences inspires greater efficiency and improved quality in the performance of traditionally government performed tasks (Nuskey, 1992).

Thirdly, the economic benefits of contracting with a private firm proficient in performing a service provided by the government can be significant, resulting in major cost

savings. Additionally, the private firm may have greater incentive to provide high quality service at lower cost than does a government agency (Kettl, 1988). Profit is a very strong motivator.

### **1. Reduced Role of Government**

Proponents of outsourcing see a zero-sum relationship between government and the economy. The larger the public sector, the smaller the private economy. The more public spending, the less private savings and investment, productivity and growth (Hanke, 1987). Additionally, a transfer of jobs to the public sector will provide entrepreneurial and business expansion opportunities and subsequently enhance commercial environment (Holzinger, 1992). The results hoped for include reduced government intervention and spending, falling unemployment, and business and investment opportunities (Nuskey, 1992).

### **2. Competition**

One of the principal attractions of outsourcing is the use of competition to control costs and improving the delivery of services. "Competition and profit incentives are far stronger efficiency tools than any bureaucratic management ploy except perhaps death that any government has ever devised." (Fitzgerald, 1988)

Many proponents of outsourcing conclude that wider competition will follow on the heels of private contractor entry into the realm of public services (Nuskey, 1992), and that particular service, previously performed by a government agency and therefore insulated from the market, becomes

subjected to normal market forces. Private firms, spurred on by competition, will presumably operate as efficiently as possible to increase their return on investment and ultimately will save taxpayer money.

Outsourcing offers the government a way to take advantage of the increased efficiency of private sector production in providing services traditionally received through the public sector, and allows the government to reap the rewards of efficient service at a competitive price. In Savas's words, "Service delivery options are essential. Total dependence on a single supplier, whether government agency or private firm, is dangerous." (Morgan, 1992) Healthy competition among private firms and even among in house and private entities to perform a service, often results in improved quality at lower costs for the government (HASC 101-31, 1990).

### **3. Economic Efficiency and Incentives**

Supporters of outsourcing believe that whether outsourcing is followed by increases competition, it will promote economic efficiency. Outsourcing improves productivity and reduces waste by providing better incentives for the management of enterprise (Nuskey, 1992). Also, contractors are often able to take advantages of economies of scale unavailable to the government that can result in significant cost savings (Prager, 1994).

By allowing firms to bid for the right to a privatization contract, competitive terms can be agreed to ahead of time and the firm that exchanges a service for an

agreed upon fee has incentive to produce the service efficiently, and would bear the cost of inefficient production - not the government (Holcombe, 1991).

It is typically assumed that private facilities operate more efficiently than the government in performing commercial activities because a contractor has incentive to consider lifecycle costs. Making a profit is the primary goal of the private firm, and a contractor that exchanges services for a fee has incentive to produce efficiently. A private supplier will be more likely to minimize costs, for the cost-savings accrue to the firm owners and perhaps indirectly, the workers themselves. That cannot be presumed for the public sector as cost-savings do not accrue to public servants (Prager, 1994).

The assumption that public sector production is inherently less efficient than the private sector rests upon the absence of the profit motive in government activities (Prager, 1994). Productivity rates are higher among private sector employees due to the profit motive - they have incentive to seek innovative ways to reduce costs. Little or no such incentive exists in the government (Hanke, 1987).

Public employees perceive that they have no direct impact on the commercial outcome of their actions. The "reward" for efficiency in governmental programs is a funding cut in the next fiscal year. Many are the advantages of having a profit-making firm engage in production vice the government, with no profits to motivate innovation or efficiency (Holcombe, 1991).

**a. Differences in Private and Public Sectors**

In order to gain further insight into the outsourcing process, it may be helpful to identify some of fundamental differences in the public and private sectors before proceeding further. When public and private sectors are compared, the government:

1. faces more complex and ambiguous tasks
2. has more difficulty implementing decisions
3. employs people with different motivation
4. engages in activities with greater symbolic significance
5. is held to stricter standards of commitment and legality
6. has greater responsibility to issues of fairness
7. must operate or appear to operate in the public interest
8. must maintain some minimal level of public support above that required by private industry (Hanke, 1987)

The flexibility of government authorities vis-a-vis contractors is more constrained than that of the private sector firm. This has direct impact on the outsourcing process. Transparency and fairness are high priorities of good government, but basically irrelevant in inter-firm relations. Hence the public sector bidding process must be structured to assure access to all potential bidders (e.g. adequate time, sealed bids, etc.). Moreover, the contract award must be perceived by all as fair; legal steps can be initiated if the rules are not adhered to precisely. (Prager, 1994)



The private firm may be more free to diverge from its announced procedures. Public authorities not only often face a more complex and costly bidding process but also a more time-consuming one. Anecdotal evidence points to extensive delays in project initiation merely because a losing contractor had tied up the government in court. (Prager, 1994)

Outsourcing can be an effective tool in the hands of the DoD. There are however, constraints on the government be they tangible or intangible that affect the way business is conducted in the public environment. Ultimately, whether a service is kept in house or outsourced, the government is responsible for the quality of that service in the eyes of the public. The above distinctions between government and the private sector are important, and as such, should be taken into account during the decision making process prior to committing to an outsourcing project.

#### **E. OUTSOURCING CONCERNS**

In contemplating a decision to outsource, advantages as well as disadvantages must be considered. There are a number of potential drawbacks to outsourcing but the following items are the most significant: (1) lack of experienced contract negotiators for the government; (2) the potential for contractor corruption; and (3) lack of competition among contractors.

##### **1. Lack of Experienced Contract Administrators**

Care must be taken to set up an agreement between the government and the contractor that contains incentives for

efficiency. The agreement must be structured so both parties can benefit from any advantages that arise.

Creating a contract that is beneficial to the government is not easy. Contractors have incentive to maximize profits, and it is not hard to imagine that a firm could produce a contract profitable enough that excess profits going to the firm greater than any bureaucratic waste generated if the government handled the production itself. (Holcombe, 1991)

The cloud looming over outsourcing is that the profit maximizing private firm is dealing with a government that may have few incentives to act efficiently and, even if it does desire to do so, it may lack the expertise to design a favorable contract with a private sector firm (Holcombe, 1991). If the private firm is allowed to pass major costs on to the government, any advantage that the government might have gained by outsourcing is removed. The firm has less incentive to be efficient and coupled with bargaining advantages, may leave the government paying more than if it did the service itself. (Holcombe, 1991)

Potential efficiency gains from outsourcing benefit the government only if government is able to write effective contracts that allow gains to be produced and the government share in them. Private firms are more likely to have the greater bargaining power in drafting these agreements. They enter negotiations as experts, while military negotiators and their civilian assistants may have less information and little experience with outsourcing. Add the profit motive and the firm will have the government backed into a corner

completely oblivious to its condition until the bills begin arriving. The cost to the military of efficient private sector production under an unfavorable outsourcing agreement could exceed the cost of less efficient producing the service by itself.

## **2. The Potential for Contractor Corruption**

The potential for corruption is another issue frequently cited when dealing with contractors. These problems are often due to flaws in the bidding or outsourcing process itself and are preventable. By making use of rigorous open bidding procedures that include a clearly defined RFP (Request for Proposal) that specifically identify exact service requirements, written evaluation criteria, along with public access to all meetings and written records dealing with the selection process, the corruption incentive for the contractor is reduced. (Hanke, 1987)

In the event of contractor corruption or even dissatisfaction by the government with the services being provided, the government pays the price in dollars and humiliation (Kettl, 1988). Dealing with an unsatisfactory contractor may be the ultimate outsourcing nightmare for many government officials.

## **3. Lack of Competition for Contracts**

As a means for providing the best services at the lowest cost, contractors require competition to stimulate the market as consumers shop around for the best buys. Unfortunately for the government, the pool of contractors for a major service often may be small or non-existent.

When government services are not subjected to competitive bidding, the contractor becomes a monopolist and consequently the government typically pays a negotiated "going rate" (Hanke, 1987). If there are not several firms submitting bids on a contract there is no true competition and the government has no choice but to pay the asking price which may be more than it costs to perform the service in house.

In some markets, competition is virtually non-existent or weak from the outset and may diminish over time. Initial suppliers may gain cumulative insider advantages and other firms respect the "turf" of the current contractor and will not underbid them. In this situation, again, outsourcing may be less rewarding for the government and much more costly. Additionally, as a monopolist, the firm sees less need to create new services or innovations, and the client has little or no way to express preferences or any alternatives to fall back on should minimum service desires not be accomplished (Hanke, 1987).

It is often difficult for the government to cancel a contract for reasons of poor performance. Even if alternate producers are readily available, the government incurs delay and additional costs in setting up a new bidding process. Additionally, the further off the shelf the good or service, such as a unique weapon or communications system, or the maintenance for such a system, the less competition. It is more difficult to write specifications and find competitive bidders for these types of services due to the complexity of

the tasks involved in production and one-of-a-kind servicing needs such equipment demand. Contractors may simply be less willing to take a risk. Larger contractors become monopolies, selling their product exclusively to the government (Kettl, 1988).

Competition itself is often constrained by other public goals such as awarding contracts to small and minority firms. The Undersecretary of Defense for Acquisition and Technology, John Deutch, said that the way the Department of Defense

...has bought things in the past has often been used as an instrument of social change. Buying from small businesses, buying from minority-owned businesses, buying from businesses that give special preferences to veterans--a whole series of restrictions have been put in place so that the government procurement process is, in part, an important and progressive instrument of change. (Technology Review, 1994)

The efficiency that competition is meant to promote in practice often loses out to these objectives.

The above sections have provided background information relevant to this thesis. An examination of actual experiences of a Navy Command in outsourcing will follow in Chapter III.

### **III.        OUTSOURCING IN PRACTICE**

#### **A.    INTRODUCTION**

There are many considerations to be assessed in making outsourcing decisions. Although certain services that are candidates for outsourcing may be similar throughout the military (e.g., food services, custodial services, utilities), each potential outsourcing project is unique and may be subject to local constraints. Therefore, the outsourcing project must be treated by officials involved on a case by case basis.

Contract operations have become a popular alternative for many government agencies other than the military. Many municipal governments have turned to outsourcing in an effort to increase efficiency and reduce cost (Mangravite and Moffitt, 1993). Prior to discussion of military outsourcing, it is useful to examine a case of an outsourcing success in a municipality.

The number of small municipalities contracting out the operation and maintenance of their entire public works operations is growing. Public/private partnership may give city public works staff opportunities to learn technical and operational skills from private firms. It also may lower costs and the administrative burden for city personnel. The experience of public works administrators in Mustang, Oklahoma is presented in the following section.

#### **B.    THE CASE OF MUSTANG, OKLAHOMA**

In September 1992, city officials in Mustang, Oklahoma entered into a partnership by assigning the operation,

maintenance, and management of its public works department to a private firm. As a result, costs have dropped, and the burden on city administrative personnel has been reduced. Mustang, incorporated in 1969, is a 12-square mile, primarily residential community with a population of 11,000 in the Oklahoma City metropolitan area. The city had purchased wastewater treatment services from Oklahoma City, but recently constructed its own wastewater treatment facilities to help ensure the continued growth of the community. (Long and Merrill, 1993)

Shortly after the January 1992 start-up of a new \$3.5 million secondary wastewater treatment facility, the city found its staff was experiencing difficulty providing proper operation of the plant's laboratory. At about the same time, city officials had also become concerned about maintaining compliance with increasing Safe Drinking Water Act requirements and new, complex testing regulations for its eight water wells. (Long and Merrill, 1993)

Taking a cue from Oklahoma City, and nearby Yukon, Oklahoma (both contract out wastewater treatment facility operations and maintenance), city leaders turned to a private firm for assistance. Houston-based Professional Services Group, Inc. (PSG) quickly provided Mustang with a certified laboratory technician, fully licensed with the Oklahoma state Department of Health, to operate and manage all laboratory functions. Through the improved performance of its laboratory operations, Mustang officials recognized that contract operations could potentially improve city water and

wastewater treatment operations as well as its other public works services. (Long and Merrill, 1993)

After conducting thorough research of contract operations, Mustang officials issued requests for proposals to more than 12 O&M firms. After receiving proposals from several firms, city officials determined the expertise and cost savings attainable by contracting out all Mustang public works services made that option worth pursuing. In September 1992, Mustang contracted PSG to assume the operation, maintenance, and management of its public works department. (Long and Merrill, 1993)

Under the agreement PSG duties include operation, maintenance, and management of Mustang's water and wastewater treatment, collection, and distribution system's meter reading; sanitation services; street maintenance; and animal control. PSG is also responsible for paying all of the department's day-to-day operating costs. The city maintains responsibility for setting user rates, customer billing, capital improvements, and long-term planning decisions. (Long and Merrill, 1993)

The firm retained 15 full-time city public works employees, providing the former city staff comparable salary rates and increased benefits. The firm also hired the city director of public works to serve as project manager. The project manager and his staff now have access to managerial and technical support personnel, and other resources of the



national firm, to aid in the development of innovative approaches to providing public works services. (Long and Merrill, 1993)

Contract operations has reduced the administrative burden typically associated with operating, maintaining, and managing a public works department. For example, the city no longer has to monitor public works payroll and process the department's purchase orders and materials contracts. This is providing Mustang city government more time to focus on planning and preparing for the continued growth of the community. (Long and Merrill, 1993)

Mustang issued a record \$7 million in residential building permits during 1992 and the rapidly growing community is presently only approximately 40 percent developed. By utilizing a private firm to operate and maintain its public works department, the city is improving its public works department while ensuring essential public works services can expand to match community growth. (Long and Merrill, 1993)

#### **1. Specialized Programs**

PSG is implementing a comprehensive employee training and development program to enhance the skills of the public works staff in Mustang. Employees are receiving classroom instruction and hands-on training in subjects ranging from wastewater treatment theory to energy and chemical conservation techniques. In addition, operators are encouraged through an incentive program to increase certification and skill levels. (Long and Merrill, 1993)

The contractor has also established a comprehensive employee safety program. Employees are supplied with steel-toed safety boots and protective eyewear. Workers are learning various safety procedures through classroom instruction, such as confined space entry, lock out/tag out, and record keeping. The staff is also provided incentives for achieving a good safety record. These safety improvements have helped to substantially reduce worker compensation claims within the department, which had been averaging approximately \$100,000 a year when operated by the city. (Long and Merrill, 1993)

To ensure that the tests performed at the city wastewater laboratory are accurate, PSG has implemented a quality assurance and quality control program, which establishes testing standards that exceed the recommendations of the EPA. Lab personnel perform daily double test validations and a monthly accuracy and precision review. A PSG laboratory standards manager performs annual audits of laboratory procedures. (Long and Merrill, 1993)

## **2. Infrastructure Maintenance**

The firm installed a computerized maintenance program, which schedules and tracks maintenance duties within the Mustang public works department. The system permits more comprehensive planning and scheduling of preventive and corrective maintenance. Potential maintenance backlogs are quickly identified and scheduled by priorities so maintenance workers can make more effective use of their time. The maintenance program also helps to increase day-to-day

efficiency of the department by optimizing equipment performance, limiting equipment downtime, and preventing costly premature equipment failures. This high degree of attention to preventive maintenance is protecting substantial city investment in infrastructure. (Long and Merrill, 1993)

At the start of contract operations and maintenance, PSG maintenance specialists performed a Comprehensive Maintenance Evaluation (CME) of more than 40 different pieces of equipment. The CME utilized vibration analysis, thermographic analysis, and electrical studies to reveal defects and inefficiencies that would have likely gone undetected until a problem occurred. For example, the CME vibration analysis revealed that three pumps (valued at more than \$50,000) at the new city wastewater facility were operating outside of design specifications and causing significant premature wear. This new information has allowed the city to contact the manufacturer and correct the problem while the pumps were still under warranty, thus averting future repair or replacement costs. (Long and Merrill, 1993)

Mustang is utilizing the private firm's technical expertise to improve public works services. For example, when plant operators at the city's new wastewater treatment facility began experiencing compliance difficulties due to excessive solids build-up, PSG (at the time still in contract negotiations with the city) quickly developed and implemented an effective solids management program for Mustang. Working closely with plant operators, the Oklahoma State Department of Health, and the EPA, the firm quickly obtained the permits

required to beneficially use the 300 dry tons of biosolids generated annually. PSG now uses a subsurface injection vehicle to apply the biosolids for use as fertilizer to several hundred acres of pasture land and cotton fields. (Long and Merrill, 1993)

The private firm recently assisted the city in the installation of an aeration system to boost the dissolved oxygen level of wastewater facility effluent. The firm designed the system as part of its contract duties for the city. All labor required for the upgrade was performed by PSG employees and the firm completed the upgrade for only the cost of materials, resulting in a 50 percent cost savings compared with the original cost estimates. The system now increases dissolved oxygen content in the effluent to a permitted level of 0.06 mg/L or more before discharge to the South Canadian River. (Long and Merrill, 1993)

The private firm is also assisting Mustang with several pending upgrades of eight water wells and the 85-mile potable water distribution system. PSG is reviewing all proposed capital improvements and is providing O&M input for designers and suggesting potential alternatives to reduce the city's capital investment. (Long and Merrill, 1993)

### **3. Conclusion**

Contract O&M of the Mustang public works department has resulted in an annual savings of about \$200,000. In addition, Mustang no longer has to bear the cost of unscheduled expenses such as overtime, lost time, pay raises, and other unplanned variables in the budget. City leaders

are planning to use a portion of these savings to finance various infrastructure expansions and improvements within the community public works department. (Long and Merrill, 1993)

During the mid-1980s, Mustang had the highest utility rates of any community in the Oklahoma City metropolitan area. Over the past six years, the city has not implemented a single rate increase for its utility customers, and does not anticipate an increase in the immediate future. Contract operations and maintenance of the Mustang public works department is helping to provide high-quality, cost-effective municipal services to the community. (Long and Merrill, 1993)

It is evident from the case of Mustang, OK, that outsourcing can be of great benefit to a government agency in terms of cost savings, increased efficiency and quality of service. An examination of outsourcing in the military environment is the focus of the next section.

### **C. BACKGROUND OF COMNAVAIRPAC**

#### **1. Mission**

The primary function of COMNAVAIRPAC is the training and logistical support of all naval air units in the Pacific to develop their operation readiness and combat efficiency for service with the U.S. Third and Seventh Fleets. Third and Seventh Fleets include more than 60,000 personnel, 1900 aircraft in more than 110 squadrons, and six aircraft carriers. Operational control of ships and aircraft is exercised by the numbered fleet commander (Third or Seventh) to whom they are assigned.

## 2. Resources

With the COMNAVAIRPAC area of influence spanning over 100 million square miles from the Arctic to the Antarctic and from the west coast of the Americas into the Indian Ocean, the authority for management control over diverse forces ashore, afloat and in the air is delegated to subordinate commanders. In 1933, four of five former Functional Wing commands completed a reorganization into nine Type Wing commands, making each wing administratively and logistically responsible for a specific type of aircraft. The nine Type Wing commanders have their headquarters along the West Coast of the United States at Naval Air Stations North Island, Miramar and Lemoore, in California, and Whidbey Island in Washington. They report directly to COMNAVAIRPAC.

Commander Fleet Air Western Pacific (COMFAIRWESTPAC) at Naval Air Facility Atsugi, Japan, and his representatives at Naval Air Facility Diego Garcia in the Indian Ocean represent COMNAVAIRPAC in the Western Pacific and Indian Ocean. Just as COMFAIRWESTPAC acts with COMNAVAIRPAC authority ashore, carrier group commanders (COMCARGRUs) serve as COMNAVAIRPAC representatives at sea.

Normally composed of one or more aircraft carriers, carriers groups with their embarked air squadrons form the heart of Navy strike capability. Four Carrier group staffs and three cruiser-destroyer groups are currently assigned to the Pacific Fleet. The aircraft carriers *USS Independence* (CV-62), *USS Kitty Hawk* (CV-63), *USS Constellation* (CV-64),

USS Nimitz (CVN-68), USS Carl Vinson (CVN-70), and USS Abraham Lincoln (CVN-72) comprise the Pacific Fleet carrier strike force.

COMNAVAIRPAC is responsible for 16 Naval Air Stations/Facilities: NAS Adak, NAS Alameda, NAS Agana, NAF Atsugi, NAS Barbers Point, NAF Misawa, NAF El Centro, NSF Diego Garcia, NAS Fallon, NAS Lemoore, NAF Kadena, NAS Miramar, NALF San Clemente, NAS Moffet Field, NAS North Island, and NAS Whidbey Island. Support also is provided for some 675 Marine Corps aircraft in the Pacific assigned to more than USMC 40 squadrons.

#### **D.    OUTSOURCING    PROFILE**

Although each station is unique, some common functions are outsourced at the majority of these stations. A list is provided in Appendix A. Often, these services are outsourced together in a large BOS (Base Operations Support) contract. If after performing the required Commercial Activities Study (which includes extensive management studies and cost analysis) it is determined that outsourcing is an appropriate measure, the wage rate is determined by DoL and a synopsis is sent to Commerce Business Daily. Once the solicitation is printed, the proposal phase begins. The POA&M for a BOS contract for Diego Garcia follows the following sequence:

1.    PACDIV receives and analyzes the proposals (3 days)
2.    PERT Eval/Price Analysis and the establishment of a competitive range (17 days)
3.    Pre-BOS contract prepared and forwarded to NAVFAC (23 days)
4.    Tech clarification request prepared (30 days)

5. NAVFAC review/pre-BC approval (14 days)
6. Request tech clarifications and receive revised tech proposals and evaluate (22 days)
7. Request and receive best and final offers (8 days)
8. Evaluate best and final offers and establish award recommendation (9 days)
9. Prepare and forward final post-BC and forward to NAVFAC, and receive EEO/PAS clearances (31 days)
10. NAVFAC reviews and approves post-BC (21 days)
11. CHINFO clearances are obtained (7 days)
12. Award BOS contract
13. Mobilization (60 days)
14. Transition (121 days)
15. Begin full performance

After the contract has been awarded and full performance begins, the station has the task of monitoring and assessing contractor performance over the duration of the contract, usually five years, with an option each year after the initial year.

COMNAVAIRPAC follows the guidance in the Commercial Activities regulations in initiating and implementing outsourcing. The next section identifies concerns that personnel involved in the process have observed as researched through personal interviews.

#### **E. MANAGERIAL CONCERNS WITH OUTSOURCING**

It is well and good that Pentagon decision makers view outsourcing as a possible solution to alleviating increasing fiscal stress. However, the majority of outsourcing is completed at an individual command level. The "people in the trenches" actually working on a daily basis with contracts



and contractors are in a position to determine exactly what works, what has potential, and what is completely off the mark regarding outsourcing with respect to their command.

In an effort to operate the Department of the Navy in the most efficient manner, command authorities have established outsourcing goals for major claimants (CINCPACFLT, July 94). Possible benefits derived from the utilization of outsourcing as a management tool to offset resource reductions have become too significant to ignore as the latest new management fad. Claimants on Navy resources have submitted plans to achieve targeted savings.

As a claimant, COMNAVAIRPAC has considerable interest in the formulation and execution of any outsourcing plans that may come from the Outsourcing Selection Committee at CINCPACFLT. Personnel at COMNAVAIRPAC work on a daily basis to carry out policy regarding any outsourcing decisions. The experiences of COMNAVAIRPAC with outsourcing may typify those of other military installations. Interviews with COMNAVAIRPAC personnel reflected a keen awareness on their part of important issues involved with outsourcing. This section addresses major concerns relative to outsourcing expressed by key COMNAVAIRPAC personnel.

#### **1. Cost Growth Problems**

Costs for operating stations supported by BOS contracts demonstrate cost growth exceeding an equivalent station operated by government resources. Reasons for this are identified in the following sections.

**a. Statutory Wage Rate Increases**

One reason for this occurrence is that statutory wage rate increases periodically provided to contractor employees outstrip wage increases to federal employees. These wage increases are applied to contracts for each option year of the contract (first initial year plus four option years) and can increase the cost of labor by as much as 10 percent per year. Since service contracts are labor intensive contracts, the costs for these wage increases are significant. (Shore Activities, COMNAVAIRPAC)

**b. Changes in Contract Requirements**

Changes in requirements can also propagate an increase in the cost of a service contract. Modifications in contract requirements typically involve an increase in services performed or an expansion of scope. Such changes necessitate contract renegotiation.

Changes in the contract due to unforeseen requirements must be added to the contract if the new requirement is within scope. A new contract must be negotiated if the additional requirements are not within contract scope. Effecting any changes in a contract or negotiating a new contract can be a slow process. Examination of the contract to determine if the new requirements are within contract scope takes time. Additionally, if new requirements can be written into the contract, they must be written accurately and precisely

worded, usually a time consuming task. Prices for the new requirements must also be negotiated. A renegotiated contract may favor the contractor in price. (Shore Activities, COMNAVAIRPAC)

If new requirements are not within the scope of the existing contract, a new contract must be negotiated. The Navy may want to retain the same contractor for the new contract but has the option of receiving bids from other contractors. The process of starting anew with a new contract is a lengthy and incurs additional costs. Renegotiations or additional new contracts drawn up to accommodate new requirements can be very expensive for the Navy. (Shore Activities, COMNAVAIRPAC)

***c. Deficiencies in Written Statement of Contract Requirements***

Another similar concern involves the actual statement of contract requirements. These requirements are often poorly written. Poorly stated requirements leave the door open for misinterpretations by the contractor on exactly what is desired by the Navy, which consequently may lead to poor contractor performance.

In this situation, re-performance is often prescribed, leading to costly delays in completion of the service. Granted, there is no perfect service contract, and the DoD is making an effort to improve the negotiating and writing process of contracting; however, there is still much to be accomplished in this area. (Shore Activities, COMNAVAIRPAC)

**e. Lack of Competition for Contracts**

The lack of competition for the contracts on some of the remote facilities in COMNAVAIRPAC care has created an untenable situation. COMNAVAIRPAC is responsible for several facilities located in remote areas. Each of these facilities is run almost exclusively by BOS contract. Costs for an overseas station such as Diego Garcia have been consistently greater than those for in house bases (see Figure 1 below) due to the fact that there is often a lack of competition among contractors for the contract to maintain and operate these types of facilities. (Comptroller, COMNAVAIRPAC)

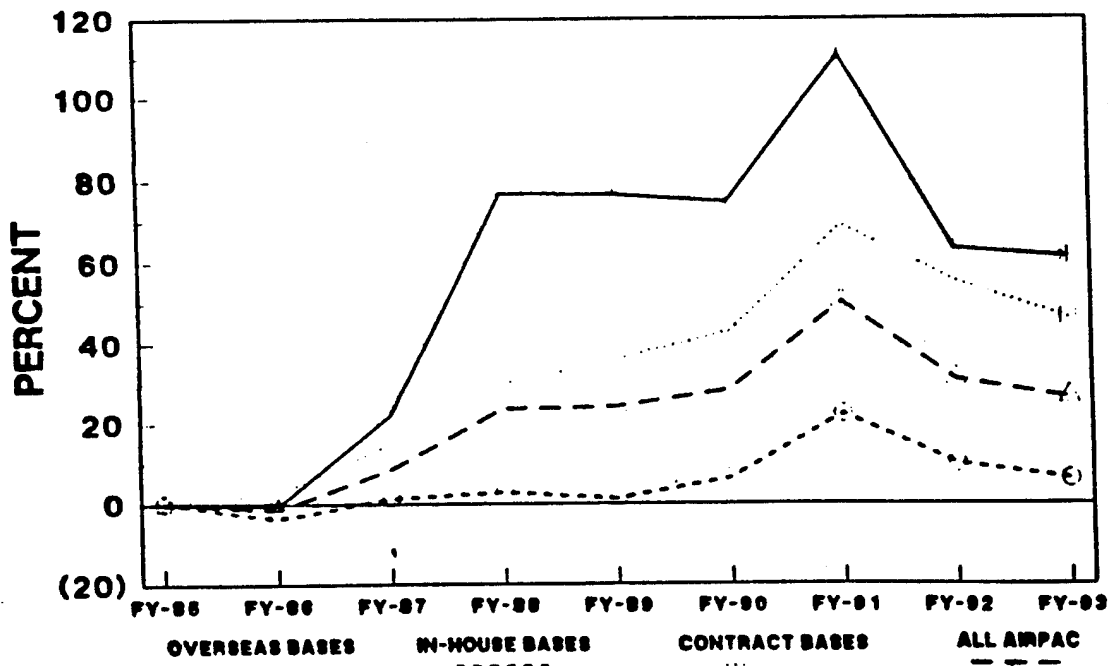


Figure 1. Percent Growth from FY-85 Baseline from Shore Activities, COMNAVAIRPAC

**d. Poor Contract Administration and Surveillance**

Poorly performed contract administration and surveillance also contribute to the cost growth problem

(Shore Activities, COMNAVAIRPAC). Contract administrators often are not subject matter experts on the type of service being contracted. Contractors can take advantage of this since they employ shrewd negotiators who know the ins and outs of there business very well indeed. Oversight is difficult as insufficient numbers of available specially qualified Navy personnel are available to monitor and control the contracting relationship.

## **2. Administrative Problems**

The following section identifies several administrative problems facing COMNAVAIRPAC as they implement an outsourcing initiative.

### **a. Lack of Contract Authority and Control of Resources**

COMNAVAIRPAC is a fleet command. It does not hold contracting authority. Therefore, it must rely on external contracting agents to develop, award, and administer contracts on its behalf. This effectively places a third party into what is already a complex and ponderous task of contracting out a service. (Shore Activities, COMNAVAIRPAC)

Within the Air Force and Army, operating commands are provided contracting authority. Within the Navy, only systems commands and certain, specialized commands are provided contracting authority and perform this function for fleet commands. Another non-value adding layer of bureaucracy in the contracting hierarchy is not conducive to producing effective operations support contracts at fleet shore stations. (Comptroller, COMNAVAIRPAC)

commanders from direct control of their resources. Commanders cannot deal directly with a contractor; they must use a contract administrator as a mediator between the contractor and themselves. Contract administrators are accountable only to the contracting agent, not the station commander. Consequently, the contract administrator's actions and performance are not within the direct chain of command, of the installation commander, and hence are beyond control. This situation may lead to goal incongruence between the contractor and the installation commander.

The contract administration process may not be compatible with the vision or goal of the installation commander. Incongruent goals can only lead to incompatibility of priorities and possible bitterness between contractor and installation as the project progresses.

(Comptroller, COMNAVAIRPAC)

#### ***b. Reduced Flexibility***

Another significant management problem with outsourcing is that of reduced flexibility. Assigning a function to contract performance is generally a one-way street. Once the service is outsourced, it is very difficult to return that service to in house performance (Shore Activities, COMNAVAIRPAC).

Billets are often cut to only a few expert personnel who remain to retain core capabilities for contingency purposes. The cost of reclaiming an outsourced service can be high. Start-up costs may be high, and escalate in the circumstance of contract cancellation due to

unsatisfactory contractor performance. As a result, outsourced functions typically remain outsourced, even in the most uncomfortable of situations for the Navy.

**c. Profit Motives of Contractors**

The profit motivation of contractors is also viewed as a area of concern by COMNAVAIRPAC personnel. On some occasions, this objective becomes all encompassing, and the quality of contractor performance suffers due to poorly written contracts. Contractors are not motivated to go beyond the minimum stated requirement. The poor condition of contractor operated stations tends to bear this out (Shore Activities, COMNAVAIRPAC).

**d. Potential for Corruption**

The potential for corruption of contractors is an issue frequently cited when discussing the disadvantages of outsourcing. The DoD has had some undeniably harrowing experiences with corrupt contractors. Unfortunately, there are probably very few government agencies that have not had to deal with this issue and COMNAVAIRPAC is no different (Budget Officer, COMNAVAIRPAC). Corruption need not be blatant theft of millions of dollars. Merely taking advantage of the mistakes of inexperienced government contract writers and administrators now and again can add up to significant amounts of money.

**F. CONCLUSIONS**

When an outsourcing success story similar to that of Mustang, Oklahoma is published, it can cause great optimism and anticipation in government channels that motivate

government agencies such as the DoD to begin new outsourcing initiatives and encourage expansion of existing programs. COMNAVAIRPAC and the Mustang public works department are both government entities, yet their experiences with outsourcing have been vastly different.

The Mustang contractor was willing and able to perform the services required within the limited realm of the operations of the public works department. The COMNAVAIRPAC situation differs for the BOS contracts in that the scope is broader. The operations and maintenance of a base encompasses a greater variety of services, and is not merely a subset of administrative and personnel duties within one department as in Mustang.

Outsourcing on a smaller scale, with functions limited in scope, has much more potential for successful implementation, as do outsourcing tasks that have an equivalent counterpart in the private sector. Requirements are more easily written for smaller specific tasks such as providing food services, or custodial services than for providing entire O&M for a base.

For example, food services and custodial services are commonly available in the private sector and would translate easily into an outsourcing scenario; however, running a base has been the military's exclusive purview until recently, and while individual tasks of the operations and maintenance of an installation may equate to a private function, the aggregate day-to-day operations may be far more intricate. Satisfactory performance in every area of such a contract is



difficult if not impossible. Monitoring a limited scope outsourcing project is significantly less complicated as well.

COMNAVAIRPAC has identified several areas in which outsourcing could result in significant savings. ADP functions, Photo Labs, Bachelor Quarters Management, Galley Operations, and Family Service Centers, Transportation, Hazardous Materials/Waste Management, Facilities Maintenance are among the programs that have realistic potential for successful outsourcing (CINCPACFLT, June 94). Police and Fire protection may provide vast cost savings when congressional restrictions are lifted and outsourcing of these functions is no longer prohibited. (Shore Activities, COMNAVAIRPAC)

Outsourcing has become a popular method of simultaneously reducing government expenditures and improving the efficiency of government services. Proponents of outsourcing point to the apparent satisfaction of most government decision makers, such as those in Mustang, OK, in achieving the dual aims of economy and efficiency. This has spurred contracting initiatives throughout the federal government, including the DoD.

Outsourcing may be successful if applied skillfully and judiciously. Mustang, Oklahoma has obviously benefited greatly from contracting out its public works department. The COMNAVAIRPAC experience with outsourcing the operations and maintenance of several its installations has not been as

good. Several items of concern were discussed in the previous section. The next chapter will analyze and interpret these concerns.



#### **IV. INTERPRETATION AND ANALYSIS**

##### **A. INTRODUCTION**

Contracting out has become a popular method of simultaneously reducing government expenditures and improving the efficiency of government services. It may be argued that the benefits of outsourcing have been the subject of much attention while the drawbacks have been quietly swept under the rug. To benefit from outsourcing, its limits must be identified and taken into consideration prior to commitment to an outsourcing initiative. An awareness and understanding of potential deficiencies may preclude monumental mistakes.

The issues raised in Chapter III are significant and varied. This chapter will discuss and analyze the problem areas identified by COMNAVAIRPAC and address each item within these problem areas.

##### **B. COST GROWTH PROBLEMS**

Costs for operating and maintaining a station supported by a BOS contract consistently exceed the costs for an equivalent station operated by in house resources. Some of the reasons for this occurrence are: (1) statutory wage increases; (2) changes in contractor requirements; (3) deficiencies in written statement of requirements; (4) poor contract administration and surveillance; and (5) lack of competition between contractors for contracts.

###### **1. Statutory Wage Rate Increases**

The law requires that contractor employees receive wage rate increases. These increases are applied to the contracts for each option year. At times, they can increase the cost

of labor by as much as 10 percent per year. These increases can exceed wage increases to federal employees. It follows that it may be cheaper to maintain the function in house if labor for the contractor is so expensive.

Since these wage rate increases are determined by the Department of Labor and usually based on the rate of inflation, the command can estimate and budget for the increase. However, if the increase is greater than the rate budgeted as was the case for one station, the station must absorb the additional cost. The contractor must be paid, therefore the money usually is extracted from another program. Recurring unbudgeted outlays are not good operating procedure.

Contractors are aware of regulations and know the DoL will provide for a wage rate increase every option year of the contract. Shrewd (or crooked) negotiators may even underbid to get the initial contract, then in the option years, make up the difference from their low bid in wage rate increases, much to the dismay and disgruntlement of the command. (Budget Officer, COMNAVAIRPAC)

COMNAVAIRPAC has watched benefits tangible during the first year of a contract evaporate in the years thereafter when the time for renewal appeared. Contractors often submit a bid, win the contract, then proceed to cut costs dramatically in whatever ways are at their disposal (e.g., by firing staff). Consequently, existing workers become so thinly spread that the quality of performance of the service suffers (Shore Activities, COMNAVAIRPAC).

## **2. Changes in Contract Requirements**

In the process of executing a contract, the need to change a requirement(s) arises. One of the most significant drawbacks to outsourcing is the reduced ability to make changes in production (Hanke, 1987). Usually, these changes are work increases. If the change is within the scope of the contract, then an additional requirement can be added to the existing contract after renegotiations of price. If the change is not within the scope of the existing contract, a new contract must be obtained. (Shore Activities, COMNAVAIRPAC)

In either event, the process to accomplish a change in a contract requirement can be an expensive evolution for the Navy in terms of both time and money due to the renegotiation process necessary for the existing contract to incorporate the changes or fresh negotiations for a new contract to fulfill the additional requirements. Price adjustments, usually increases, invariably occur. A change in a requirement at a non-contract base is not nearly as expensive or time consuming. An equivalent service performed at a non-contract station would probably be accomplished at less cost (Shore Activities, COMNAVAIRPAC).

## **3. Deficiencies in Written Statements of Contract Requirements**

Outsourcing has been suggested as a method for reducing expenditures on services traditionally provided by the public sector. In evaluating production of a good or service for outsourcing, it is not enough to merely demonstrate that private enterprise could perform the job more efficiently.

Contract terms must ensure that some of the gains from this productivity are shared with the government. The challenge is to create agreements that make government better off than if it operated its own facility (Holcombe, 1991).

An old axiom that may be applied here is, "If you want something done right the first time, do it yourself." It can be a very arduous task to communicate to a contractor exactly what is desired on paper. Unfortunately, the consequences of poorly written contracts can be devastating. Contractors employ highly skilled writers who are experts in their field. These people are very quick to spot weaknesses in a government contract and will exploit their advantage (Budget Officer, COMNAVAIRPAC). Often, the contractor has at his disposal various legal remedies that can serve to increase the contract price because federal acquisition regulations can favor the contractor over the government (Shore Activities, COMNAVAIRPAC).

The people who write government contracts play a critical role in the outsourcing process. Their civilian counterparts are willing to spend the time required to ensure that the verbiage is correct and precise, leaving no room for interpretational discrepancies. In short, it is their job to see that the contract is in the best interests of their company. The government, it would appear from COMNAVAIRPAC concerns, does not have the same dedicated equivalent.

Often, the government does not have subject matter experts to cover every type of contract and begin the negotiations with a distinct disadvantage. Individuals who

write government contracts are integral to the success of an outsourcing initiative. The present caliber of training of these professionals in government service is below par and their abilities must be honed (Friedberg, 1991). Multi-million dollar mistakes are not uncommon. There would be fewer mistakes of this magnitude if the contract writer for the government was held accountable for the error and be well compensated for their successes (Budget Officer, COMNAVAIRPAC). The importance of a well-written contract cannot be underestimated.

#### **4. Poor Contract Administration and Surveillance**

Poorly performed contract administration and surveillance contribute to the cost growth problem (Shore Activities, COMNAVAIRPAC). Contract administrators are often not subject matter experts on the type of service being contracted, which leads to difficulties in oversight of the contract. A significant disadvantage to outsourcing is a reduced ability to monitor performance (Hanke, 1987).

After a firm has been awarded a contract, the Navy must be prepared to monitor and control to the extent possible, contractor performance. Monitoring is used primarily as a preventive, not a punitive measure. Ideally, monitoring will uncover nothing but the fact that the contractor is in compliance with all provisions. Monitoring does entail additional costs to the government but these may be cheaper than the potential price of not monitoring. Efficient monitoring, although costly, typically will pay for itself by preventing overcharges and poor quality performance in the



first place, by recouping inappropriate outlays, and by disallowing payment for inadequate performance (Prager, 1994).

Monitoring for quality control refers to comparing the quantity and quality of product or service delivered against contract specifications. Product quality normally is simpler to monitor than service quality, because product specifications tend to be more precise. More intense monitoring is called for when the contracted good is vital and service disruption will have substantial deleterious consequences (Prager, 1994).

Additionally, monitoring is even more critical when the contractor incentive and ability to cheat is present. The costs of monitoring can be significant. Sometimes, managing a contract can lead to the creation of a large contracting bureaucracy within the contractee's organization. The costs of managing outsourcing can exceed the costs of producing the service in house (Prager, 1994).

Contracts do not monitor themselves and contracts that demand complex monitoring are likely to be inadequately or inefficiently monitored. In such instances, in house production may be less costly as the apparent savings from outsourcing are overwhelmed by monitoring and other contracting costs. The Navy must resist pressure to outsource until the need for quality contract management is met and adequate resources are devoted to it. (Prager, 1994)

## 5. Lack of Competition for Contracts

"The injection of competition into the procurement process is the critical feature of outsourcing that ensures expected cost savings." (Morgan, 1992).

COMNAVAIRPAC concerns regarding competition are well founded. In an area where competitive contractors exist in plenty such as a large city, the Navy appears to benefit from outsourcing. However, in a remote or isolated location, the advantages of outsourcing are reduced since the Navy may have to pay premium price for contractor provided services (e.g., Fallon). In this situation, retaining the function in house may be the most worthwhile option.

Competition may give the Navy the flexibility of switching among alternate suppliers and enhanced bargaining power. If the Navy has the opportunity to purchase goods elsewhere, then the contractor may be less likely to pass costs on to the government since competition works best when the pool of potential suppliers is large (Morgan, 1992). However, the advantages are only worthwhile if the Navy can assure itself of both the reliability of services and the ability to maintain competition later at points of contract renewal (Hanke, 1987).

The absence of an adequate number of vendors competing will yield less than optimal results. The absence of market competition among contractors should induce the government to consider in house production even when the good or service is available from a contractor whose costs are lower. In essence, the government is looking to eliminate monopolies

and encourage competition between suppliers. Through these measures, it hopes to force the entity to run more efficiently (including those in house entities) and at lower prices.

Often, selecting a contractor is a complex process. Competition among contractors plays a key role because the most efficient manner of choosing a contractor is through a competitive bidding process. Collusion among bidders is a real danger, because the incentive structure of competitive bids is designed to benefit the contractee at the expense of the bidders. Even the potential winning bidder may gain from a collusive arrangement, because both the contract award is higher and the cost of bidding is lower. Even if there are multiple bidders, competition cannot taken for granted for in its absence, the gains from contracting will be diminished if not dissipated entirely (Prager, 1994).

COMNAVAIRPAC experience with the lack of competition probably is not unique. There is simply not enough competition for the contracts to maintain and operate their remote facilities. Consequently, the Navy pays premium prices for the maintenance and operations of lower priority bases while facing funding cuts that inevitably are absorbed by the higher priority bases (Comptroller, COMNAVAIRPAC). COMNAVAIRPAC does not presently save money by outsourcing in a competition vacuum (Comptroller, COMNAVAIRPAC). Competition must be present to maximize the potential benefits of outsourcing. Otherwise, it would be more cost effective to keep the services in house.

### **C. MANAGERIAL CONCERNS**

Administration of a contract is a complex process. The concerns identified by COMNAVAIRPAC surrounding this process are discussed in the following sections. The issues include: (1) lack of contracting authority and control of resources; (2) reduced flexibility; (3) the profit motives of contractors; and (4) potential corruption

#### **1. Lack of Contract Authority and Control of Resources**

COMNAVAIRPAC is a fleet command and does not hold contracting authority. The command must rely on a third party for the development and administration of the contract. Adding another loop in an already complicated process only serves to generate confusion and increases the probability of communication and interpretational errors.

As noted, in the Navy, only the systems commands and certain specialized commands have contracting authority. The Army and Air Force provide their operating commands with contracting authority. It is unfortunate that the Navy has not extended its fleet commanders the privilege. Commanders are charged with acting in the best interests of their installation and the Navy. They most likely know best the contracting needs of their organization. If advice or assistance is required, they can apply to the appropriate authority and receive whatever support necessary as they act in the best interest of their commands. An extra layer of bureaucracy often slows the process down to a crawl and

frustrates personnel, especially if the third party sees the command contracting requirements as something other than what the commanding officer determines.

Similarly, service contracts remove station commanders from direct control of their resources. Since a commander cannot deal directly with a contractor, the contract administrator is his only link to the firm doing the work for his facility. Contract administrators are accountable to the contracting agent, therefore the facility commander exercises no direct control over contract administrator actions.

Misunderstandings on the intent of the contract, requirements, or even conflicts in goals for the installation add to the turmoil already inherent in the contracting process. If there should be a serious disagreement between contractor and commander over an issue such as an equitable adjustment, an appeal to the Armed Services Board of Contracting may give the contractor the benefit of the doubt and find in his favor, leaving the commander with no further recourse (Shore Activities, COMNAVAIRPAC). The reputation of the contractor gained in the treatment of its past contracts, and smooth resolution of differences in contract interpretation, are items to consider when initially selecting a contractor to avoid expensive delays resulting from misunderstandings.

A united front is vital to the success of the outsourcing and is a product of clear communication between the commander and the contract administrator.

## 2. Reduced Flexibility

It is extremely difficult for the Navy to impose meaningful penalties on delinquent contractors. Cancellation is the only real penalty for bad performance and it is so severe that the pressures to avoid it are tremendous. If invoked, it often is more painful for the Navy due to severe penalties written into contracts in the event of this circumstance, than for the contractor. The penalty may be more costly to the Navy than maintaining the contractor until completion of the contract. Additionally, cancellation leaves officials with the unpleasant task of starting from the beginning finding producers and restarting the bidding process anew.

Once a function has been outsourced it is very costly to reclaim that function. Military billets may have been cut, facilities, materials and equipment sold. In short, the experienced personnel required, and the wherewithal to perform such a reclaimed service would have to be recovered from ground zero. The costs of starting production of a good or service may be high, much more than switching contractors. (Shore Activities, COMNAVAIRPAC)

Additionally, a command that has already committed time and effort into exploring and advocating the commitment to outsource may be "inclined" to sign a less favorable agreement with the contractor rather than admit failure and begin the bidding process anew or revert back to government provision of the service due to political pressure. Government contracts provide employment for many voters.

Another critical aspect of reduced flexibility involves the force readiness factor. Should the United States become involved in a conflict requiring the mobilization of DoD components, commanders must have the capability and capacity to respond immediately to the demands of the President and Congress. While outsourcing may be an effective cost reducing tool in the near future in the existing peacetime setting, its long-term effects may be detrimental to the military in some cases depending on the particular outsourced function. Retaining "core capability" of an outsourced service may not be sufficient to meet contingency demands placed on a private firm in a wartime environment.

The military may have to supplement a contractor, or reclaim an outsourced service using military personnel whose skill level has declined due to extensive outsourcing of that service. Gaps result in other critical areas because of the loss and inefficient performance (at least initially) may have serious repercussions on DoD efforts. Loss of ownership of facilities, and equipment relinquished to contractors during an outsourcing project may also have a negative impact on overall readiness.

### **3. Contractor Incentives Stem From Profit**

According to COMNAVAIRPAC, the prime motivation for contractors is profit. On some occasions, this objective becomes all encompassing, and the quality of contractor performance suffers. In COMNAVAIRPAC experience, some of their BOS contractors often have not been motivated to perform beyond minimum requirements as evidenced by the

conditions of the contractor operated stations (Shore Activities, COMNAVAIRPAC).

The drive to efficient production supposedly stems from the profit motive. A contractor will work to minimize costs hoping to share in the firm's profit because after all, the purpose of doing business is to make a profit. Contractor desire to turn a profit, however, should not automatically be correlated with its ability to perform a service efficiently, with high quality. (Prager, 1994)

Contract design, whether it be fixed cost plus or incentive, also plays a vital role in how efficiently and effectively a contractor operates. The cost plus contract invites "moral hazard" since contractor incentive to hold down costs is eroded. The government pays for any additional costs incurred. The contractor has no incentive to operate efficiently because there is nothing extra to be gained by performing beyond minimum requirements.

On the other hand, incentive contracts shift risk onto the contractor. Efficient performance can yield high rewards for the contractor while the price of inefficient performance may be expensive. The contractor will either benefit directly or pay for the overruns according to performance. Although contractors profit from productivity improvement, they may also lose when costs beyond contractor control turn up. (Prager, 1994)

Improved quality is often touted as a significant advantage to outsourcing. Studies have found that private sector performs many equivalent services at costs



significantly lower than the government at levels of quality as high or higher (Fitzgerald, 1988). However, studies sometimes lack evidence about the quality of services, therefore making it difficult to judge whether lower costs result from greater efficiency or deteriorating quality. Some evidence does suggest that private producers have lower costs, but the picture is complicated by other studies showing no difference in costs or even higher costs among commercial providers (Hanke, 1987).

Quality does not necessarily come automatically when a function is outsourced. Frequently, the military has selected contractors solely on a low bid basis. Unfortunately, the sacrifice of quality for the cheaper rate has often proven to be a costly mistake for the Navy and the DoD. (Hanke, 1987)

Not always will a firm award the contract to the lowest bidder. Other considerations are also taken into account such as past performance, reliability, and capacity. This may be a time consuming process but the avoidance of "low-balling" as well as the weeding out of poor potential and actual performers suggests that total contracting costs will be lower and quality higher in the long run. (Prager, 1994)

#### **a. Different Incentives in Government**

The incentive structure of the military is completely different from that of the private sector. There are few or no pressures produced by competition or the profit motive (Fitzgerald, 1988) with the recent exception of DBOF (Defense Business Operating Fund).

When compared to the incentives motivating the private contractor to good performance, the government and the military may appear woefully outgunned. However well the profit motive spurs private contractors to greater heights of efficiency, the government has other of motivational tools at its disposal.

Monetary rewards do stimulate goal achievement but they are not the only type of incentive. Power, prestige, and altruistic "service to country" are all viable motives. Many people are willing to sacrifice monetary rewards for the power attainable in government positions. Additionally, the package of benefits that go along with base pay, job security, promotional opportunities are motives to compare to those offered in the private sector (Prager, 1994).

The issue of public versus private sector efficiency may not lie exclusively in different attitudes toward monetary motivation. The willingness to address the bottom line can be identical whether the incentive is profit or an equally potent nonfinancial motivator. The evidence that private ownership is more efficient than public enterprise cannot be taken at face value. There is an assumption among advocates of outsourcing that private managers can deliver at lower costs services similar or superior to public managers. In fact, many public employees are as efficient as are private sector companies. (Prager, 1994)

It is no surprise that government operated activities are inefficient when public policy makers

deemphasize efficiency as a goal of the public sector, when management is not provided with sufficient flexibility to pursue efficiency goals, and when the incentive structure of the public sector either is neutral toward or even discourages cost saving. The issue is not inherent inefficiency as much as a lack of political will to establish efficiency as a high level priority of government operations.

Profit may indeed be what motivates most contractors to perform effectively and efficiently. Not many are in business out of the goodness of their heart. The government has been criticized for its inefficiencies, however, this is not always due to lack of motivation of government employees.

#### **4. Danger of Contractor Corruption**

Past public perceptions of defense contracting tend to fixate on revelations of \$600 toilet seats and \$436 hammers among other allegations of waste, fraud and abuse. For the average citizen, such stories tempt the conclusion that the entire outsourcing concept amounts to a feast for the corporate greedy. Often overlooked is the extent to which the Department of Defense and Congress share the blame for creating and encouraging abuses (Fitzgerald, 1988).

Congressional involvement in the procurement process is such that each member may seek to assure that those defense dollars reach his or her district regardless of long term consequences on the procurement system. The DoD has been a good customer for companies in a great many congressional

districts, and members of congress do not want to see changes that will shift jobs out of their districts. (Defense Technology, 1994).

Overcharges by contractors sometimes result from accounting methods mandated by Congress that require the pricing of overhead charges on spare parts and other centralized purchasing procedure devised to prevent the very waste that is perpetrated. Overpriced toilet seats and hammers do not occur because the Pentagon buys too many of these items too quickly, but too few too slowly in strict accordance with regulation. The allocation of overhead to fewer items has caused cost distortion in some cases. (Holzinger, 1992)



## V. RECOMMENDATIONS AND CONCLUSIONS

### A. INTRODUCTION

The DoD began an outsourcing initiative with OMB A-76. In doing its part to fully implement this initiative, the Navy has charged commanders with reaching targeted savings goals utilizing outsourcing as a means of achieving them. This thesis began with a discussion of the reasons for the trend of outsourcing including: (1) the growing cost-revenue squeeze on government; (2) public disillusionment with government programs; and (3) the magnitude of the federal deficit.

Some generally accepted benefits of outsourcing were identified: (1) release of government from day-to-day oversight of operations; (2) the injection of competition inspires greater efficiency and quality of workmanship; and (3) significant economic benefits derived. Items of distinction between the public and private sectors were identified to assist in understanding what constraints the government must operate under as opposed to the relative freedom of the private sector.

Some common concerns with outsourcing were then noted: (1) lack of experienced contract negotiators; (2) potential for contractor corruption; and (3) lack of competition between contractors for a contract.

The next chapter discussed outsourcing in the public sector in practice. The successful outsourcing of the Mustang, Oklahoma public works department was noted and discussed, followed by a discussion of the outsourcing

experience at COMNAVAIRPAC in San Diego, California. The concerns of COMNAVAIRPAC personnel were highlighted. They included: Cost growth problems of (1) statutory wage rate increases; (2) changes in contract requirements; (3) deficiencies in written statements of contracts; (4) poor administration and surveillance of contracts and contractors; and (5) lack of competition for contracts. Administrative concerns were (1) lack of contracting authority and control of resources; (2) reduced flexibility; (3) profit motives of contractors; and (4) the potential for contractor corruption. Chapter IV provided analysis and interpretation of these concerns.

## **B. RECOMMENDATIONS**

### **1. Define Contract Requirements and State Them Precisely**

Only if the work to be performed is defined succinctly, and stated without ambiguity can a contractor and client maintain a good working relationship and achieve the established objectives. The officials in the Mustang, Oklahoma public works department obviously were working with an experienced, well qualified contractor. The aims of the contract were specific and consequently, the outsourcing initiative was effective due to this and other reasons mentioned. COMNAVAIRPAC experience with its BOS contracted stations indicate that the terms of the contract at times are not being written clearly or specifically enough.

## **2. Continue to Improve Training for Contract Administrators**

Knowledgeable contract administrators are vital to the success of an outsourcing initiative. These personnel must be brought up to the performance capability standards of their private sector counterparts. The DoD cannot afford to be at a disadvantage in the early stages of the contracting process. Millions of dollars can be lost by improper administration of contracts.

## **3. Factor in the Cost of Oversight**

If a successful outsourcing project is desired, then costs of monitoring the execution of the function must be taken into account at the inception of the outsourcing plan.

The Navy must be prepared to monitor contractor performance. Monitoring does entail additional costs, but these may be cheaper than the potential price of not monitoring. Efficient monitoring should eventually pay for itself by preventing overcharges and poor quality performance in the first place, by recouping inappropriate outlays, and by disallowing payment for inadequate performance. However, when the costs of managing the contract outweigh the cost of maintaining the service in house, outsourcing is inappropriate (Prager, 1994). Actual costs are difficult to estimate in advance.

## **4. Ensure a Competitive Environment Exists Among Contractors**

Competition between contractors is present, the government is able to negotiate for a competitive level of output at a competitive price. The contractor in turn has



incentive to produce the service efficiently as the firm bears the cost of inefficient production. (Holcombe, 1991) If there is no market and, therefore, no competition among contractors to provide a service to the government, much of the gains of competition will not be passed on to the government by contractors. The costs most definitely will be passed on. There is little advantage in contracting out to a monopolist, other things equal.

#### **5. Take Precautions Against Contractor Corruption**

In the private sector, a business may outsource when it is not cost effective to produce the good or service in house. This will hinge on the technology of production, the efficiency of its organizational structure, and the degree of market competition. Each of these items is variable. Therefore, the outsourcing decision must be under continual review.

Although it is difficult and costly to reclaim an outsourced function, it is not impossible to do so. The Navy must be aware of that option should any of the above mentioned variables change. The Navy must be flexible and not merely accept the status quo merely because the task has traditionally been accomplished in a particular manner.

A thorough investigation of a contractors may assist the Navy in coming to a decision on which contractor to engage to increase the probability of success. In the awarding of contracts, bidder past performance on defense contracts should be taken into account more fully. Company past performance record may be an important indication of the

quality of its subsequent work. Focusing on past accomplishments provides an incentive for improvement in these difficult fiscal times.

The Navy must synchronize goals with the contracting firm, and the primacy of Navy goals must be established. Less than optimal results will be extracted if all concerned are not united in purpose (Hyman, 1993).

Additionally, the government needs reliable feedback from contractors that is not filtered and distorted. No contractor wants to get locked into a bargain that allows no maneuvering room in event of change. The same is true of government. Government officials also desire flexibility in shaping goals with a contractor - the two parties must find a point of intersection to achieve optimal results (Kettl, 1988).

The costs of the contract process - design, monitoring, control, etc., must be calculated as accurately as possible to avoid excessive, surprise expenses. Inevitably there will be some unforeseen costs, but major corruption can be minimized with meticulous planning and dogged oversight.

Extensive records should be kept on every outsourcing initiative. The DoD has done enough contracting out to have the necessary information compiled in a comprehensive database. Outsourcing activities can then have access to all pertinent data (who, what, where, when, why, how...) regarding the process of outsourcing from the solicitation of bids to contract renewals, including design, oversight, and control costs of each outsourcing endeavor. Access to

information regarding the experience of other military commands in outsourcing can prevent repetition of mistakes and provide a mechanism for making more accurate estimates of costs involved to assist in the prevention of cost overruns.

### **C. CONCLUSIONS**

Outsourcing has become a prescriptive to reduce the size of government and lower costs. Outsourcing does not necessarily provide cheaper or more efficient goods and services. Neither is outsourcing inherently better than performing services in house. The differences hinge on three key issues: setting standards and contractor goals, creating or using competition, and effective oversight (Kettl, 1988).

Outsourcing of DoD services will neither reduce government outlays nor increase government efficiency unless decision to contract makes economic sense. Outsourcing may improve the short term budget picture, however, military authorities have an obligation to address long term issues. Outsourcing may be the appropriate tool to use at present, but unless it is used with discretion, the far reaching effects may be detrimental to national security interests in terms of force readiness.

Outsourcing may be an effective tool for the Department of Defense with judicial use if the following points are considered:

1. Sole bids from one contractor will not result in significant savings. Hidden monopolies will work against efficiency goals.
2. There is a continuous need to monitor and regulate. The government will never be relieved of this responsibility.

3. There must be competition to realize savings. Multiple vendors must be available in most circumstances to achieve efficiencies.
4. Monitoring costs can often outweigh the benefits of outsourcing.
5. Costs of failure can be high. Outsourcing may fail due to lack of quality, bankruptcy of the contractor, or other factors. Government may have to take over, or bear the transition cost or loss of service entirely. (Hanke, 1988)

Regardless of the selection of in house or outsource, the government will be held accountable and responsible for the consequences of that decision and ultimately for economic growth and national security (Nuskey, 1992). Outsourcing is a healthy trend that can reduce incentive for waste and temper political pressures to continue inefficient government services. However, it is not a cure for all economic ailments of the Navy and DoD. The outsourcing initiative offers an opportunity to re-examine contracting out with an eye to raising productivity and paring costs. (Fitzgerald, 1988)

The Pentagon may not be a shining example of efficiency and reform but, compared to other government agencies, it does not do too badly (Technology Today, 1994). Some government operations can be efficiently outsourced, but others cannot. The current challenge to DoD and Navy officials is to make correct distinctions.



## **APPENDIX**

### **COMNAVAIRPAC OUTSOURCED FUNCTIONS**

Management and Administration  
Hazardous Wastes Collection, Storage and Disposal  
Antenna Maintenance  
Custodial Services  
Grounds Structures Maintenance  
Pest Control  
Utilities Management  
Electrical Power Production  
Auxiliary and Portable Engine Generator Unit  
Electrical Distribution System  
Telephone System  
Steam and Domestic Hot Water Heating Systems  
Potable Water System  
Sewage Systems  
Communications, Computer and Radar Systems  
Transportation Operations and Maintenance  
Solid Wastes Collection and Disposal  
Resale/Service Activities  
Food Services  
Billeting  
Vehicle Maintenance  
Morale, Welfare and Recreation Services  
Engineering and Maintenance Control Services  
Buildings and Structures Maintenance and Repair  
Photographic Services  
Bachelor Quarters  
Supply Services  
Fuels Management Operations  
Audiovisual Services  
Public Works Support Services  
Housing Maintenance  
Swimming Pool Maintenance  
Gas Distribution System  
Air Passenger Terminal and Air Cargo Service  
Tugboat Services  
Port and Harbor Services  
Maintenance and Repair of Aircraft  
Laundry and Dry Cleaning  
Automatic Data Processing Services

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